A New Way to Organize Social Enterprise

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Introduction - New Thoughts on the L³C

It has been a little over 4 years since the first L³C law passed in Vermont. It took 20 years from the time the first LLC law passed in Wyoming in 1978 until all the states had recognized the LLC. But how we are in era of instant gratification. So the question keeps getting asked, “if the L³C is so good why haven’t all the states passed the laws?” We need to appreciate that just because the internet can tweet a new idea to millions in minutes that the rest of life will not change that fast. The legislative process moves in spurts. There are always the early adopters who understand the promise of a new idea and then there are those who want to wait to see what everyone else does. I remember testifying before a legislative committee before any state had adopted the law and at the end of my testimony I said, “…and you can be the first state to adopt this law.” Whereupon one legislator promptly said, “I don’t cotton much to number one. I prefer to be number 25.” The first state law was passed in 2008 just before the beginning of the Great Recession. That recession has made it challenging to finance any venture let alone a new one built upon a relatively untried structure. It is way too early to judge the L³C. There are many happy users and some who are disappointed because they thought organizing as an L³C would bring foundations to their door with bundles of cash. Unfortunately, or maybe fortunately, no form of business organization eliminates the need for a good business plan and as a new idea the L³C will undoubtedly take a while longer to gain widespread acceptance.

There is almost universal agreement that access to capital for solving social problems is the number one problem in the social sector. This paper is a presentation on a solution to that problem that we have been developing over the last several years—the L³C (Low-profit Limited Liability Company, a business structure designed to encourage commercial capital markets and market rate investors to invest in solving social problems. With any new model there are questions about the short and long term implications. This paper attempts to provide an explanation of the L³C and the rationale behind it. I will attempt to answer the criticism of those, who I am afraid, do not understand the L³C and I will help advance the discussion and implementation of this new business structure.

There is no one in the social sector who is not aware of the difficulties of raising enough money just to keep the doors open. Even the large portion of the nonprofit sector that provides services to government agencies in exchange for fees is woefully undercapitalized. Nonprofits are often forced to borrow money or take other drastic measures just to keep their heads above water. Individual donors and foundation supporters frequently want their money to be used for programs not general overhead. All of this leaves nonprofit leaders feeling they are always making sub-optimal decisions. The L³C provides a solution.
Background

I created the L3C in a manner designed to overcome many of the problems facing the social sector by creating a vehicle which was a for profit but was legally committed to charitable activities. I call the L3C the for profit with the nonprofit soul. The L3C is not a nonprofit. It is a for profit venture that under its state charter must have a primary goal of performing a socially beneficial purpose not maximizing income.

Interestingly it is the public, not the lawyers who tend to get the L3C. For them it is a foundation for how to organize a for profit to perform charitable activities. They do not have years of legal training and would not know where to start. Just because a lawyer can construct an LLC with charitable goals in mind does not mean the “garage” entrepreneurs wants to spend their hard earned savings on a lawyer. They want to get on with the business not organization. It is yet another example of bureaucracy vs. entrepreneurship. We are destroying free enterprise in this country because instead of providing a foundation for organization we are trying to specify where every brick is going. It is the nature of entrepreneurs to start small and somewhat disorganized and add structure and organization as they succeed. The L3C first and foremost is a for profit venture but one whose primary job is to fulfill a charitable mission. Most of the L3Cs that have been formed were organized by those who did not want charitable money involved. In a survey of L3Cs the number one reason for choosing the L3C vehicle was to avoid being burdened by the regulation and cost of the nonprofit sector. They wanted to do good their way - the nature of entrepreneurs. It reflects the desire of many Americans to follow our free enterprise system and operate without a lot of government regulation and reporting requirements. According to the World Economic Forum’s 2012 - 2013 Global Competitiveness Report the US is now only 7th in a world ranking of economic competitiveness. Canadian think tank Fraser Institute ranks the US 7th in its ranking of most to least free countries for 2013. We need creative free enterprise.

The legislation establishing the L3C was specifically written to dovetail with IRS regulations relevant to Program Related Investments (PRIs) by foundations to promote increased use of these investment forms. The regulations detailing the PRI are not only rules for obtaining a specific type of financing but also provide an excellent basis for best practices for a for profit that wants to perform charitable activities. The dual benefit of the PRI regulations made it a win-win situation to use them as the basis for the L3C. The L3C laws that have been passed so far basically state:

A limited liability company that is a low-profit limited liability company must be organized for a business purpose that satisfies, and is at all times operated to satisfy, each of the following requirements:

(a) The limited liability company (i) significantly furthers the accomplishment of one or more purposes set forth in Section 170(c)(2)(B) of the Internal Revenue Code, and (ii) would not have been formed but for the entity’s relationship to the accomplishment of such one or more purposes;

(b) No significant purpose of the limited liability company is the production of income or the appreciation of property; provided, however, that the fact that the entity produces significant income or capital appreciation shall not, in the absence of other factors, be
conclusive evidence of a significant purpose involving the production of income or the appreciation of property; and

(c) No purpose of the limited liability company is to accomplish one or more political or legislative purposes within the meaning of section 170(c)(2)(D) of the Internal Revenue Code of 1986, as amended.

L3C’s facilitate PRI investment along with tranched (layered) investing where the PRI usually takes the first risk position thereby reducing risk for other investors in higher return tranches. These tranches become more attractive to commercial investment because the high risk tranche investor has improved the credit rating of the entire structure and thereby lowered the total cost of capital. In a normal tranched structure the high risk investor (venture capitalist) usually takes a large piece of the ownership and asks for a high rate of return to offset the significant number of losses they incur overall. If a foundation granting a PRI takes the first loss position with a low rate of return without asking for a big piece the social enterprise that would normally operate in the red can become self sustaining.

Why would a foundation do this? A foundation is required by law to give away or invest in PRIs approximately 5% of its endowment every year. By nature charitable donations are high risk and low financial return. The foundation essentially loses its entire grant and earns nothing in the way of income. The PRI law was designed to create a profile for PRIs that resembled a grant. It was a high risk investment that provided little or no return while furthering a charitable purpose (Section 170(c)(2)(B) of the Internal Revenue Code)

The multiplier effect potential here is very important since foundations have a total endowment of about 500 billion dollars but the market rate sector represents a pool of over 13 trillion dollars. The leveraging potential foundation dollars could bring if just a small piece of that money could be brought to bear on social issues is huge. The L3C is particularly favorable to equity investment, because foundations or other charitable investors take the highest risk at little or no return, the venture capital model is essentially turned on its head and many social enterprises will now have a low enough cost of capital that they are able to be self-sustaining. It is the perfect vehicle for economic development, medical research, operation of social service agencies, museums, concert venues, housing and any other activity with both a charitable purpose and an ability to produce a revenue stream.

Like the LLC framework the L3C is built on, the L3C provides a way to start small and unencumbered, for very little money, build a business, and become more sophisticated along the way. When the L3C is ready for serious financing it has already operated in a manner consistent with the regulations for PRIs. The L3C was also built on the LLC platform to take advantage of the LLC’s structural flexibility. The governing document of an L3C and an LLC is the Operating Agreement. The operating agreement is just a contract among the members (shareholders) of an LLC or L3C. It outlines the relationships among the members, the purposes of the organization and the manner in which it will do business. Since the L3C is a legal business form with specific requirements as specified above, the members are constrained to write the operating agreement in a manner consistent with L3C law. That same law also places a fiduciary responsibility on the
owners and managers to operate in a manner consistent with the law. This is the dual beauty of the L3C. The public and investors can be ensured that the L3C is required by law to operate within the constraints of the law while the owners and managers otherwise have the flexibility of the LLC business structure.

Because it is a variant form of LLC the L3C is now legal in all 50 states as a result of legislation signed into law in Vermont in April 2008, Michigan in January 2009, the Crow Indian Nation in January 2009, Wyoming in February 2009, Utah in March 2009, the Oglala Sioux in July 2009, Illinois in August 2009, Maine in April 2010, Louisiana in June 2010, North Carolina in August 2010 and Rhode Island in June 2011. An L3C from any of these states, like a Delaware corporation, can be used anywhere. The L3C bill is now active in the legislatures of many states.

The L3C is a firmly established, 100% legal alternative way of creating a vehicle to perform socially beneficial activities. As of January 2013 about 1000 have already been formed since mid 2008. Many of these were formed with the same entrepreneurial spirit that forms small business. Rather than go through the expensive and lengthy process needed to form a nonprofit they formed an L3C. Their total cost was as little as $100 (Vermont fee) and they were in business. They are operating out of their spare room, garage or basement much in the spirit of Steve Jobs, Bill Gates or Henry Ford. They can rent their garage from themselves, hire their spouses or otherwise do the things that small businesses do without worrying about IRS rules on personal inurement. They can use their own money and pay themselves back out of revenue. They can keep their books on Quick Books and have the L3C treated as a pass through for tax purposes. In many cases they will not even need an accountant. Like the standard for profit entrepreneur who is planning on looking for more financing later they can invest their own money, get it back at an appropriate time and wait to ask a foundation for a PRI. They can test out their idea without having to begin with a complex fund raising campaign after having waited months for the IRS to approve their 1023. Others may want or need a very structured organization from day one. No problem, the L3C works just as well. In all cases these entities will operate as a for profit business with one important exception. Under the state law of the state they are registered in they must put mission before profit although there are no strict limits on what is an acceptable level of profit. IRS regulations and examples on PRIs make it clear that a high profit result is acceptable as long as it is not the primary goal.

The money used to capitalize an L3C is not tax deductible nor is it usually solicited from the general public. If it were to be it would be in the form of a public offering and be under the auspices of the SEC (another tough regulator.) So there is no danger of an L3C using its status to defraud the public out of donation dollars. It must have a charitable purpose that comes before profit and that is in the various state laws and is subject to enforcement by the various States Attorneys General. So the confluence of nonprofit purpose with a specially designed for profit vehicle manifests itself in the L3C. For more detail on the L3C visit http://americansforcommunitydevelopment.org/

Although private letter rulings or other federal intervention are not required to use an L3C, we see the potential benefit of federal legislation to enhance the value, ease of use, and flexibility of the L3C. To that end, we have promoted The Philanthropic Facilitation Act.(PFA) The objective of the proposed legislation is to facilitate PRIs by private foundations, in part by amending section
4944(c) of the Code to provide a process by which an entity seeking to receive PRIs can receive a determination that below-market foundation investments in such entity will qualify as PRIs. The registration via the PFA will be voluntary. Those who wish to operate without foundation or DAF (Donor Advised Fund) funding or whom already have a friendly foundation partner need not be bothered.

Probably more importantly than anything else, the L³C is a brand which signifies to the world that it puts mission before profit yet is self sustaining. As a brand it makes these concepts easy to grasp and thereby will be frequently used.
Q & A

The following questions and responses are a result of the input of many people over the last few years. The L³C is a new idea but we built it on a solid business and legal foundation. Many of the questions were raised by critics and state regulatory officials. Some may seem redundant of information provided above but are targeted to specific challenges raised.

1. Federal Legislation

Although federal legislation to support L³Cs and PRIs is under consideration, given the absence of federal legislation how should this impact state legislation? Although IRS private letter rulings are not required, many suggest the IRS process for obtaining private letter rulings is a key barrier to increased use of PRIs by private foundations. Will the L³C which is purported to facilitate use of PRIs without Private Letter Rulings be enough or should we wait for federal legislation?

The L³C legislation is independent of federal legislation and stands on its own. Congress is not in the innovation business. They react to events they do not try to create new concepts. So they will not pass legislation until they see the need. That means every time another state passes the L³C bill there is more pressure on DC. But the federal piece is not required. The IRS has long approved LLCs as PRI recipients and as the Section on Taxation of the ABA has pointed out, the L³C as a variant form of LLC would not raise any issues of applicability. See http://americansforcommunitydevelopment.org/publications.php then ABA Section of Taxation - Comments on Proposed Additional Examples on Program-Related Investments.

2. “Off The Shelf”

Doesn’t the L³C concept risk creating confusion by suggesting there is an “off the shelf” solution for complex PRI transactions. PRIs are complex endeavors, but couldn’t the L³C legislation potentially give tax-exempt entities the false impression that investments in such entities would automatically qualify as program-related investments under IRC § 4944(c)? If PRIs are not structured properly private foundations risk losing their exempt status and incurring excise taxes. In addition, foundations that invest in for-profits are required to exercise expenditure responsibility, including obtaining annual reports from the L³C that account for foundations’ investments. If this bill does not change any of those facts will the potential for abuse of this new business model increase? If is not yet fully understood, and it is unclear how to regulate the charitable piece of L³Cs how will we be sure it is operating in a charitable manner? The L³C bill may raise several concerns relating to the protection of charitable assets. There is no clear existing guidance as to how much of an L³C’s profits could lawfully be distributed before those distributions might be deemed to interfere with the accomplishment of the L³C’s charitable objectives. Aren’t L³Cs allowed to distribute some portion of their profits to individual investors, rather than utilizing those profits to advance the entity’s charitable objectives? Traditional nonprofit entities are required to reinvest all of their net earnings to further their charitable purposes.

Neither ACD or any other reputable supporter of the L³C has ever made “off the shelf” claims. What we have said and continue to say is that by creating a template and a vehicle the L³C will
facilitate structuring of PRIs. The legal profession deals in forms and templates everyday. There are forms for contracts, wills, prenuptial agreements, etc. A vehicle especially designed for PRIs around which there is an ever growing body of legal history, examples and suggested media will reduce transactional costs, make the process more transparent and more understandable. Some PRIs are very complex, some are not, but the fact that so many PRIs are done as one offs leads to many complications. This is compounded by the fact that there are not a lot done so the attorneys involved are often inexperienced. The risk is on the foundation side and the IRS expects them to carry the responsibility for compliance so it is a non issue from a state law perspective.

Many states have Charitable Solicitations Acts and it is often thought that because the L3C performs a charitable activity it needs to meet these standards. False. The acts are not concerned with whether or not the alleged charity performs charitable acts. They are concerned with whether or not the alleged charity solicits money, and often grants a tax deduction, from the public promising the public that the money will be used for charitable purposes.

The L3C is a for profit. If we extend the law to cover the charitable acts of for profits where does it stop? Charitable laws are designed to protect the public from being defrauded not to judge the work of an organization. There is no need to judge the amount of charitable work done by an L3C. Even a nonprofit is not legally judged on how much work it does. Many nonprofits are extremely inefficient. There is little any regulation can do to promote efficiency. Again if there is a foundation investor then they will be the responsible party since the IRS holds them responsible.

3. Is State Charitable Registration Required?

Could the L3C legislation potentially give the false impression that because they are obligated to further charitable objectives, L3Cs fit the definition of charitable organization and should register under relevant state laws or be subject to regulation by appropriate state officials who regulate charities? There are no enforcement mechanisms to insure that the L3C carries out a charitable purpose. Couldn’t foundations be defrauded and get in trouble with the IRS?

There are no charitable investments in the sense we understand charitable investment. The only money that is charitable is that of a foundation or a Donor Advised Fund (DAF) which are not donations solicited from the public at large. In the business world investors are separated essentially by law according to assets and expectation of expertise and ability to loose their investment without suffering. The so called sophisticated investor takes higher risk and gets far less help and sympathy from regulators if the investment goes south. We make the same case for foundation investment of a PRI in an L3C. The foundation has or is supposed to have trained personnel or available consultants and attorneys who are capable of investigating and making informed decisions as to whether or not any given PRI is within the parameters established by the IRS. The foundation is not risking its endowment on the PRI. It is required by law to grant, make PRIs or perform other charitable acts with 5% of its asset value each year. So if it lost all of its investment in a PRI in any given year it would not jeopardize its ability to perform in any way. In fact foundations frequently make grants that can be labeled as failures.

As the ultimate regulator of foundations, the IRS has made it clear that it places the foundation in the sophisticated investor role and holds the foundation responsible if it makes a bad PRI. There is generally no enforcement action taken against the other parties involved in a bad PRI any more than there is action taken against a private equity fund that sells an investor an investment
that goes south. The only time action is taken is when there is a clear cut case of fraud. In that case there are more than adequate civil and criminal fraud remedies on the books to handle the situation. These laws are all predicated on the basis that the government need only step in if innocent parties are hurt by the actions of others.

4. UPMIFA

Won’t the PRIs made by a foundation into an L³C be a violation of the Uniform Prudent Management of Institutional Funds Act? (UPMIFA)

The opposite is true. Under IRS regulations PRIs must be the equivalent of a jeopardizing investment because it otherwise would not have a profile similar to a grant and could not be used to replace a grant to meet the 5% rule. Also foundation dollars should not be used to compete with for profit businesses. Nonprofits are supposed to operate in a space that for profit businesses cannot or will not operate in a way that makes their services available to those who need them. The terms Low-profit Limited Liability Company and Program Related Investments apply to expected outcomes only. They are not meant to be all inclusive descriptions. The money a foundation is using for a PRI is not endowment funds to be invested. It is money that has already been selected to be used by the foundation for grants, PRIs or other charitable activities. The IRS has a whole separate set of regulations that apply to the use of those funds. The funds that are invested in PRIs are often referred to as off the books investments. Once removed from the endowment and allocated to PRIs the funds are no longer carried on the foundation books as an asset covered by the 5% rule and cannot be returned to the endowment. If the PRI eventually returns to the foundation for whatever reason the foundation has one year to use it for a grant, another PRI or other charitable purpose.

I have written before that a foundation that has a long term goal such as building a museum for 10 million dollars after 10 years might make one million dollar PRI loans to various projects every year for 10 years such that all the loans will become due at the end of year ten. It will have performed qualifying charitable acts for each of the 10 years and then used the money again in year 11 for another charitable act. The PRI is the use of already designated charitable dollars for charitable purposes that happen to embody making an investment rather than giving a grant, etc. The name L³C unfortunately creates some confusion because it is not meant to imply that the L³C is restricted to making a small profit. The name signifies that the entity will operate in a space where normal to high levels of profit are not usually expected and therefore discourages for profit investors to invest. However, the IRS regulations that the L³C is based on make it clear that an outcome that results in high profit is acceptable as long as it was generally not planned for or expected. Some of the investors in an L³C may make market rate of return. In fact this is true in many PRIs. The Gates Foundation makes PRIs to drug companies because the drug companies are concerned with the ROI they would receive on their investment if they put research dollars into finding a cure for an orphan disease. They use Gates’ money to fund the research and then are very happy to manufacture and distribute the drug because now they have an extremely high ROI on the investment they make in the drug. One of the reasons I used the LLC platform as a basis for the L³C was to create a platform that was conducive to tranched investment in order to attract market rate capital to invest alongside subsidized capital. The IRS encourages leveraging which brings market rate capital to bear on social programs.
5. Further UPMIFA

To what extent do directors of charitable foundations or members of L3Cs have fiduciary duties under UPMIFA to investigate and select investment partners that require the least subsidization?

None. As stated in section 4 above, UPMIFA does not apply to PRIs since a PRI is made with funds that have been removed from the endowment and designated for distribution as a grant, PRI, or spent on a charitable program. In any for-profit business deal there are many factors that determine investment decisions. And clearly, the foundation may select a partner(s) that requires more subsidization if they feel the mission will be best served and the L3C most likely to remain sustainable even if that partner requires a greater investment.

6. Foundations and For Profit Partners

A similar question often asked is: Should foundations be undertaking capital-intensive, high risk joint ventures with for-profit partners?

PRIs were intended to facilitate joint investments by foundations and commercial interests in a way that accomplished charitable purposes, and have been permitted since 1969. When describing approved PRIs, the examples in the regulations use phrases such as:

- Conventional sources of funds are unwilling or unable to provide funds…. Treas. Reg. § 53.4944-3(b),
- Conventional sources of funds are unwilling to provide funds…at reasonable rates…. Treas. Reg. § 53.4944-
- Conventional sources of funds are unwilling or unable to provide funds …at reasonable rates…. Treas. Reg. § 53.4944-3(b)
- Y, a private foundation, makes a loan to X [a business enterprise] at an interest rate below the market rate for commercial loans of comparable risk. Treas. Reg. § 53.4944-3(b)
- Y, a private foundation, makes a loan to X [described as a business enterprise which is financially secure and the stock of which is listed and traded on a national exchange] at an interest rate below the market rate to induce X to establish a new plant in a deteriorated urban area which, because of the high risks involved, X would be unwilling to establish absent such inducement. Treas. Reg. § 53.4944-3(b)
- Y, a private foundation, makes a high-risk investment in low-income housing... Treas. Reg. §53.4944-3(b),

All of the Examples of approved PRIs in the Treasury Regulations involve risk levels that are unacceptable to normal financial investors, and all of the examples involve highly capital intensive projects such as the construction of manufacturing plants and low-income housing. Moreover, current economic conditions suggest a need for greater deployment of foundation funds in PRIs in order to help alleviate economic and social distress. Once again it needs to be pointed out that the foundation funds involved are not endowment dollars. They are funds that are already removed from the endowment to be deployed for charitable activities.
7. Compatibility of Low Profit & Market Rate of Return Investors

*If a significant portion of an L3Cs capital is provided by investors seeking market rates of return, how can it be said that the production of income is not a significant purpose of the L3C? There is no clear existing guidance as to how much of an L3C’s profits could lawfully be distributed before those distributions might be deemed to interfere with the accomplishment of the L3C’s charitable objectives. L3Cs are allowed to distribute some portion of their profits to individual investors, rather than utilizing those profits to advance the entity’s charitable objectives. Traditional nonprofit entities are required to reinvest all of their net earnings to further their charitable purposes.*

First there is a misunderstanding between the terms profit and cost of money. If a nonprofit borrows money, it must pay market rate for this money and no regulator ever questions it as long as it is market rate. The L3C concept provides that the primary purpose of the organization must be charitable, with the production of net income permitted to be a secondary purpose. It must generate sufficient revenue to pay the cost of attracting equity investment or pay interest on borrowed funds. Investors in a normal for profit business who take high risk demand very high return on their investment. The L3C with high risk investors who are willing to take a low return is able to operate as a for profit where a normal for profit cannot. As with a tax-exempt charity that must have a charitable purpose by law, yet also must, from an economic standpoint, have sufficient revenue to conduct operations, institutional decisions must be made with the L3Cs over arching charitable purpose in mind. In many cases the blended rate of return in an L3C may be below market but individual rates at market and others below market. The L3C should avoid planning on paying above market rates of return in any tranche. Thus, the L3C brings together foundations PRIs, Donor Advised Funds and other charitable investments with investments by non-exempt parties to accomplish the L3C’s primary charitable purpose through a business that, because of its inherent risk and low likelihood of significant profit, simply would not be attractive solely to for-profit investors.

Precisely the same analytic framework that applies under current law to assess the purpose and fiscal operations of a tax-exempt charity will apply to an L3C. When assessing whether a significant purpose of a foundation’s proposed investment is the production of income for purposes of the PRI rules, Treas. Reg. § 1.501(c)(3)-1(d)(2) provides that the term charitable includes the promotion of social welfare by organizations designed to (1) lessen neighborhood tensions, (2) eliminate prejudice and discrimination, (3) combat community deterioration, or (4) combat juvenile delinquency. As the following examples illustrate, the IRS generally draws on these criteria when evaluating whether jobs creation and economic development activities qualify as charitable under § 501(c)(3) of the Code.

In Rev. Rul. 70-585 (1970-2 C.B. 115) a community organization was formed to plan the rehabilitation and renewal of an area in a deteriorated urban area where the median income level was lower than in other sections of the city. The organization purchased an apartment house that it planned to rehabilitate and rent to low- and moderate-income families, with preference given to residents of the area. The IRS ruled that since the organization’s purposes and activities combat community deterioration by assisting in the rehabilitation of an old and run-down residential area, they are charitable within the meaning of § 501(c)(3)
8. State Legislation and the IRS

*Does the state legislation allowing for the formation of L³Cs create an opportunity for foundations to circumvent the IRS rules?*

No. The state L³C legislation, as well as the proposed federal legislation are exclusively anti-abuse measures. Neither creates a legal benefit that does not already exist. Further, both legislative initiatives preserve the existing safeguards in chapter 42 of the Code while creating additional safeguards and enforcement mechanisms to ensure that PRIs accomplish charitable purposes.

9. Safeguards to Insure Charitable Purpose

*What safeguards and enforcement mechanisms are in place to ensure that L³Cs are not only organized for charitable purposes, but they also operate in a manner consistent with those purposes? If the L³C must have a charitable purpose does that mean every activity of the L³C must be charitable?*

The overall purpose of the L³C is to perform one or more charitable activities but in order to do so it must earn revenue. If it could earn sufficient revenue from performing a charitable purpose to be totally self sustaining it would not need to be an L³C. A doctor arguably performs a charitable service but is able to charge significantly for that service. The law permits an L³C to engage in one or more businesses that are not directly related to its mission. Endless Sky L³C is being formed in Montana for the express purpose of processing food for the food banks and soup kitchens in Montana. In order to do so it will create and market a high end iconic branded retail line of food which it will sell at market price. But the revenues from that line, will support the food bank line. The revenue from the retail line will cover the entire overhead and profit not used to repay investors will also go to support the food bank line. In fact Endless Sky could not function except for its non charitable product line. The point here is that everything the L³C does must support the charitable mission.

An L³C is not automatically, and does not seek to qualify as, a tax-exempt entity and it could not do so unless all the requirements for that status are met, as has been made clear by the IRS. Rather, it is anticipated that many L³Cs will be structured to eventually qualify as recipients of equity PRIs, with both taxable and tax-exempt owners. The L³Cs are, themselves, taxable entities. In every version of the state L³C legislation that has been enacted, the definition of an L³C was carefully drafted to encompass the PRI requirements set out in the Treasury Regulations.

Presently, such taxable L³Cs are subject to the same PRI oversight mechanisms as all other for-profit entities (including traditional LLCs and corporations) that receive PRIs from foundations. Before making an investment, the foundation may, but is not required to, secure a private letter ruling from the IRS, or an opinion of counsel, stating that the investment will qualify as a PRI. Once the PRI has been made, the foundation is required to exercise expenditure responsibility (due diligence) over the investment. This includes obtaining annual financial reports from the PRI recipient, which account for the foundation's investment, and a statement that the PRI recipient complied with the terms of the investment. The L³C structure will further facilitate this monitoring because as a member of the L³C the foundation, if it feels the need, will be able to require one or more seats on the management board of the L³C. In addition, the foundation is required to report the PRI to the IRS on its annual information return (Form 990-PF).

By enacting legislation that recognizes the L³C, states are creating a business form with an
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identifiable designation - L3C. The presence of the L3C designation signals to state regulators that the entity is organized and operated to accomplish charitable or educational purposes. When state law requires or charitable dollars are involved regulators may implement programs or mechanisms to monitor whether those requirements are being met. Indeed, it is virtually impossible for state regulators to currently identify taxable entities operating under a charitable purpose unless the organizations have been formed as L3Cs. If the only charitable funds involved are those from a PRI then the state really has no role since PRIs are governed by federal law.

The proposed federal legislation creates a new mechanism for IRS oversight and approval of PRIs that consumes fewer IRS and foundation resources than the private letter ruling process by providing that the PRI recipient (rather than each foundation) requests IRS approval of the proposed PRI. The proposed approval process, like the current private letter ruling process, is voluntary. However, because the process is streamlined and because the PRI recipient can anticipate more funding if it has received IRS approval, the regime proposed in draft legislation should encourage voluntary requests for IRS review of these arrangements.

In addition, the draft federal legislation creates a mandatory reporting requirement for entities that have been approved to receive PRIs where none currently exists under either federal or state law. Thus, the federal legislation should improve both the transparency of the PRI process and the accountability of organizations that receive charitable funding by establishing a clearly-defined screening mechanism within the IRS.

10. Is Economic Development Charitable?

Under what circumstances are economic development projects or job creation programs considered charitable under § 501(c)(3) of the Code?

Reg. § 1.501(c)(3)-1(d)(2) provides that the term charitable includes the promotion of social welfare by organizations designed to (1) lessen neighborhood tensions, (2) eliminate prejudice and discrimination, (3) combat community deterioration, or (4) combat juvenile delinquency. As the following examples illustrate, the IRS generally draws on these criteria when evaluating whether jobs creation and economic development activities qualify as charitable under § 501(c)(3) of the Code.

In Rev. Rul. 70-585 (1970-2 C.B.115) a community organization was formed to plan the rehabilitation and renewal of an area in a deteriorated urban area where the median income level was lower than in other sections of the city. The organization purchased an apartment house that it planned to rehabilitate and rent to low- and moderate-income families, with preference given to residents of the area. The IRS ruled that since the organization’s purposes and activities combat community deterioration by assisting in the rehabilitation of an old and run-down residential area, they are charitable within the meaning of § 501(c)(3) of the Code. In the same ruling, the IRS considered an organization that was formed to construct housing facilities that would help families to secure safe and affordable homes in an area where the high cost of land, interest rates, and the growing population had produced a shortage of housing for moderate income families. In contrast to the first example, the IRS ruled that this organization did not qualify for exemption because its program is not designed to provide relief to the poor or to carry out any other charitable purpose within the meaning of the Treasury Regulations applicable to § 501(c)(3).

In Rev. Rul. 74-587 (1974-2 C.B.162 ) the IRS considered whether an organization formed to
stimulate economic development in high-density urban areas inhabited mainly by low-income minority or other disadvantaged groups qualified as charitable. The organization provided funds and working capital to corporations or individual proprietors who were not able to obtain conventional financing because of the poor financial risks involved in establishing and operating enterprises in communities or because of their membership in minority or other disadvantaged groups. The IRS ruled that the organization qualified because it (1) demonstrated that the disadvantaged residents of an impoverished area can operate businesses successfully if given the opportunity and proper guidance, (2) assisted local businesses that would provide a means of livelihood and expanded job opportunities for unemployed or underemployed area residents, and (3) helped to establish businesses in the area and rehabilitated existing businesses that had deteriorated. The IRS specifically explained: Although some of the individuals receiving financial assistance in their business endeavors under the organization’s program may not themselves qualify as charitable, the recipients of the loans and working capital in such cases are merely the instruments by which the charitable purposes are sought to be accomplished.

Thus, even though the organization did not provide financial support directly to members of a traditional charitable class, its activities still were deemed charitable since they benefited the disadvantaged community as a whole. It is worth noting that the preceding IRS rulings have been in place and operating as effective guidance for more than 35 years.

11. Foundations, For Profit Investors & Significant Income

If a private foundation investor is required under the terms of an L3C operating agreement to cover any loss or a portion of a loss to for-profit investors seeking a market return on their investment, does this arrangement make the production of income a significant purpose?

If a private foundation investor is required under the terms of an L3C operating agreement to make an additional capital investment, does this arrangement make the production of income a significant purpose?

Tax policy, which has been in place since 1969 and that underlies the concept of a PRI - namely, that private interests will benefit, but in the course of deriving that benefit, a far greater public benefit will be attained through the over arching charitable purpose of the PRI. Under federal tax law, such private benefit is deemed incidental and regularly occurs in many charitable relationships. For example, when a student receives a scholarship to attend college, the student receives a benefit that will result in life-long personal financial return, yet the act of granting the scholarship assistance is a traditional charitable act.

Treas. Reg. § 53.4944-3(b), Ex. 8, describes a situation in which a foundation makes an appropriate PRI in the form of an equity investment in a business that subsequently experiences financial and management problems. The business is managed by a third-party under a contract that provides broad operating authority to the manager and compensation provisions that include a share of the profits and an option to buy the stock held by the foundation or the assets of the corporation. Most importantly, the management agreement obligates the foundation to contribute toward working capital requirements. Viewed in the context of an agreement that provides for a profit share and right of purchase, a contractual duty to provide working capital is essentially a guarantee of an economic return to the for-profit manager. The regulation goes on to conclude that none of the terms and conditions jeopardizes the continuing treatment of the foundation’s investment as a PRI.
As a consequence, such contractual provisions such as being required to cover a loss or make additional capital contributions, are in fact, legally appropriate in the context of a PRI under long-standing federal and state charity law by virtue of the incorporation of the private foundation excise tax regime into state law. (For examples see, Colo. Rev. Stat. § 7-121-501 (2008); N.C. Gen. Stat. § 55A-1-150 (2008); Wyo. Stat. § 17-19-150.)

In practice however, the foundation wields considerable authority to negotiate the terms of the L3C operating agreement because the foundation’s high-risk and low-return PRIs serve as the financial backbone of the entity, strengthening its balance sheet, improving its credit rating, thereby making it possible for the other investors to earn higher returns. Foundations have many worthwhile options for investing or donating their charitable assets and foundation managers are required by law to be prudent stewards of those assets. Given these realities, it is unlikely that a foundation would agree to an arrangement where it was subsidizing the returns to profit-seeking investors, unless such a provision was necessary to attract significant capital infusion into the socially-beneficial enterprise to achieve the charitable goals of the PRI.

12. Production of Income

What are the factors that determine whether the production of income is a significant purpose?

The IRS does not identify a set of factors to determine whether the production of income is a significant purpose of a PRI. However, Treas. Reg. § 53.4944-3(a)(2)(iii) explains that the IRS finds it relevant whether investors solely engaged in the investment for profit would be likely to make the investment on the same terms as the private foundation.

For example, in Priv. Ltr Rul. 199910066, a private foundation interested in assisting in the revitalization of blighted communities entered into a limited partnership with a limited liability company as the general partner. The partnership raised funds to use as seed capital and first stage financing for start-up high technology ventures. Some of the companies in which the partnership invested would have been unable to obtain conventional financing. The funds invested by the foundation, as a limited partner, were used to invest in technology businesses that agreed to place their operations in areas of the community determined by a governmental body to be blighted or depressed. The companies had to agree that the investment could be redeemed or repaid if they failed to maintain operations in the community. Because these restrictions were imposed on the use of the foundation’s invested funds, the IRS concluded that the purpose of the investment was not the production of income or the appreciation of property and that the investment qualified as a PRI.


If there is no federal legislation or change in IRS policy concerning PRI and L3Cs, does state L3C legislation serve any purpose?

Yes. The incorporation of the L3Cs concept into LLC statutes at the state level provides a consistent legal structure for socially-beneficial enterprises and a means, through the L3Cs designation, for the public, regulators and grant-makers to identify them. Without such statutes
in place, the public and state regulators would have no ability to identify such enterprises and determine whether or not they should register under state charitable solicitation rules or other regulatory regimes. Additionally the state regulation creates a fiduciary responsibility upon the managers of the L³C to carry out the charitable mission at the expense of profits. Presumably this would permit a state AG to take action against the managers of an L³C that were not in compliance.

14. Do We Need Better Reporting Requirements?

There seem to be inadequate reporting requirements concerning the accomplishment of significant charitable or educational purposes by the L³C and the amount of distributions to private individuals. Should the combination of charitable assets in ventures with for-profit partners be done in an open, transparent manner? Does the L³C stand to make such combinations more complex and more difficult to understand and monitor? L³Cs that sell goods or services to the public may promote themselves as deserving of public support and patronage because of their L³C status and their stated commitment to advance socially beneficial purposes. Existing law does not contain adequate public reporting requirements or other mechanisms through which the public could obtain and evaluate information about how L³Cs are accomplishing the promoted charitable or educational purposes and the extent to which the L³C’s profits are being reinvested for public purposes or distributed to private individuals. Should such reporting be required? Should, similar to reporting obligations imposed by federal law upon IRC § 501(c)(3) organization? Should L³Cs be required to report their PRIs (including detailed financial information) on an IRS-approved informational return that must be made public, and similar to requirements imposed by state law upon many nonprofits, should L³Cs be required to register under state charitable solicitation acts? Should similar requirements imposed by state law upon many nonprofits, be imposed on L³Cs with certain minimum revenues or assets (e.g., $1 million) to obtain annual, audited financial statements and provide those statements to the state agency responsible for regulating nonprofits?

These proposals are made by those who cannot seem to grasp the idea that L³Cs do not use publicly donated charitable dollars. In the sense they use charitable dollars it is money from foundations or DAFs which are already regulated and required to monitor their investments. The L³C, unlike a nonprofit, does not solicit public funds and does not use charitable dollars to subsidize its operations. The investments made in the form of PRIs into L³Cs are a form of subsidization of capital not operations and support the L³C by reducing its cost of capital and hence its operating expenses.

Interestingly enough the L³C designation significantly improves transparency. The PRI regulations have been law since 1969 and during that time it has been generally impossible for either the states or the IRS to track all the PRIs that have been made, know who they were made to, or have any idea of the outcomes. The only mechanism for over forty years for reporting PRIs has been as a line item on the 990-PF of a foundation making a PRI. The L³C as a branding mechanism will serve to announce an organization that promises charitable purpose and flag the possibility that a PRI is in place here. The mechanism for tracking L³C performance is via a foundation investor if there is one. If there is not, there is no reason that public examination should be required since there is no charitable investor. The purpose of most charitable laws is to insure that the donor can
be confident that the donated dollars will be used for charitable purposes. It is up to the foundation to be sure its PRI is being used properly and to this end the foundation is responsible to the IRS. Reporting requirements are also unfair to L3Cs of any size which choose to operate with only private investment. The L3C is a for profit that happens to do good but so what. As for public perception, if a toy company says its toy will make a child happy for hundreds of hours there are no toy police which go out and check on child pleasures. This is a matter of free enterprise response. Dozens of companies claim to give all or some portion of their profits to charity. Others claim a portion of revenue goes to a cause. There is no requirement that they account for their money although some have been examined under false claims acts. But this shows that if there is valid suspicion there are also already adequate enforcement mechanisms on the books. We seem to be locked into the misguided idea that we all have the right to know how an organization that claims to do good is performing. We don’t. It runs entirely contrary to our basic free enterprise, capitalist system. We make our own independent decisions every day among the thousands of goods and services in front of us. We may look to others for advice or recommendations but the decisions are ours. If we do not think the L3C museum is offering enough value for its purported claims then we will not go there.

15. L3Cs Absent Nonprofit Partners

*Is it possible for an L3C to operate without a foundation or other charitable investor?*

Yes. It is important to note that many of the L3Cs that are being formed have no intention of asking foundations for money. Many of the early adopters have looked at the L3C for its social branding and simplicity of structure vs. forming a nonprofit. It is really a social entrepreneur’s dream. Sit down this afternoon and decide if there is a societal need that can be filled by a properly run for profit. Go on line to a state like Vermont and form an L3C for $100. Get up tomorrow morning and start doing business - no lawyers, no lengthy IRS registration process, no burdensome regulations which really are most appropriate for a public charity asking the public for donations. Finally social entrepreneurs can organically grow a charitable organization in the same manner as a standard for profit. It might be a part time business for the first two years. If they get big enough to require significant capital they can then go the foundation route.

16. L3Cs and Security Regulations

*If an L3C needs to raise money from the commercial markets, what special regulations regarding securities registration and regulation of an L3C are needed?*

None. As a variant form of LLC the L3C is subject to the same state and federal securities regulations as any LLC. These regulations are very extensive and cover every possible eventuality. Nothing in the L3C legislation gives an L3C any new rights or exemptions in this area.

17. Why Not Use the LLC Operating Agreement to Create a Special Purpose LLC rather than creating an L3C?

*Attorneys, consultants, accountants and foundations have been using LLCs, corporations, partnerships, operating agreements and PRIs for years to create organizations that function*
the same as an L³C. Why do we need L³Cs?

For years doctors have used traditional surgical methods to resolve many medical issues. In the last couple of decades, many doctors have started using the far less invasive arthroscopic type techniques which reduce pain, risk, and recovery time. Given the option, most patients choose less invasive surgery. It, however, is much more specialized with tools oriented toward only one type of operation. The L³C, as previously stated, creates a brand which makes recognition of an organization created for charitable purposes easy to find. It also allows the creation of standardized materials such as operating agreement templates, suggested best practices, etc., which create a framework for L³Cs. Just as there is an LLC for Dummies in the not too distant future, there will be an L³C for Dummies. The growing body of information is, for the most part, in the public realm or easily accessible to the public. The incorporation of the L³C concept into LLC statutes at the state level provides a consistent legal structure for socially-beneficial enterprises and a means, through the L³C designation, for the public, regulators, and grantmakers to identify them. Without such statutes in place, regulators would have no ability to identify such enterprises and determine whether or not they should register under state charitable solicitation rules or other regulatory regimes.

The transactional costs are constantly coming down vs. the old method in which most of the intellectual property belongs to professionals who charge hundreds of dollars per hour for access. The concept, if it exists solely in state law, may not significantly reduce the current transactional costs associated with a foundation making a PRI investment. Those transactional costs, primarily a result of current cumbersome and inefficient IRS administrative rulings procedures, inhibit foundations from employing their resources in socially-beneficial ways permitted under existing state and federal law. Our proposed federal legislation directs the IRS to implement a process that will be a cost-efficient and far more effective process for screening proposed PRI investments. The more L³Cs that are formed, the more likely federal legislation to this effect will pass.

18. IRS & L³C Tax Issues

Is the IRS studying the issue to determine the tax consequences of L³Cs or approval of the L³C structure?

The IRS has not issued a ruling specifically analyzing whether a foundation’s investment in an L³C qualifies as a PRI and is extremely unlikely to do so. However, the IRS has long approved foundation investments in for-profit entities, including importantly, LLCs, as PRIs, where the entity satisfied the PRI requirements. While these rulings do not reference the L³C by name, they are helpful nonetheless because they analyze the federal tax consequences of charitable investments in entities that are similar to, if not indistinguishable from L³Cs. The IRS is charged with reviewing individual PRIs after they are made. They do this by noting the foundation’s listing of their PRIs on their 990-PFs. The IRS does not make advance rulings unless so requested in a particular situation via a request for a private letter ruling. They will never give blanket approval to L³Cs as a category since this runs contrary to their review mandate. ACD does not support and has never asked the IRS for a blanket ruling. This would interfere with their ability to do their job properly and provide necessary oversight. The Section on Taxation of the ABA has taken notice of the L³C as a possible PRI vehicle and blessed same.
19. Compliance Issues

Are there any proposed reporting and disclosure requirements that would facilitate the verification of and compliance with L3C requirements and state oversight over charitable organizations and assets? Is there any other current method for the IRS, the states and the public to receive L3C specific information from a charitable investor?

Our proposed federal legislation provides for a voluntary process wherein an entity seeking to receive PRIs (e.g., an L3C) may request an IRS determination that foundation investments in the entity will qualify as PRIs. This process is analogous to the IRS determination process for entities seeking to qualify as tax-exempt under § 501(c)(3) of the Code and should ensure that the structure and proposed activities of the entity comply with the PRI requirements. In addition, the proposed federal legislation requires each PRI-qualified entity that has received an IRS determination to file an information return with the IRS for any taxable year in which it receives or retains one or more PRIs. The return must contain the following information about the entity:

- Add a new section to Chapter 60 of the Code to require information returns for for-profit entities receiving PRIs requiring disclosure of:
  - Its gross income for the year;
  - Its expenses attributable to such income, incurred within the year;
  - A narrative statement describing the disbursements for and the results obtained from the use of assets for the exempt purposes of the entity;
  - A balance sheet showing its assets, liabilities and net worth as of the beginning of such year;
  - The names and addresses of all private foundations investing PRIs in the for-profit entity.
  - A statement of the portion of its liabilities and net worth that represent capitalization from PRIs as of the beginning of such year;
  - A statement of any interest, dividends or other distributions paid with respect to any PRIs during the year;
  - Such other information as the Secretary may by forms or regulations prescribe, and
- Add a new section to Chapter 61 of the Code to require publication of aforementioned information returns for for-profit entities receiving PRIs. GuideStar has already agreed to post L3C annual reports to the IRS on its website.

This information, together with the information disclosed on the foundations’ Form 990-PF, should enable the IRS to verify an L3C’s compliance with the PRI requirements and facilitate oversight over the entity by state regulators. Thus, the proposed federal legislation provides a mechanism for regulatory oversight of PRI recipients where none currently exists. Aside from the Form 990 and Form 990-PF disclosures, the IRS does not currently have another method for tracking information concerning PRIs in any entity. Further, absent a congressional amendment to the Code, the IRS could not publicly disclose or require an L3C to disclose the L3Cs partnership or corporate tax filings.
It must be remembered that both a 1023 application for nonprofit status and the proposed application for PRI approval are based on promises to keep. It is impossible to know exactly what a nonprofit will do once it is in business and likewise the challenges of operating a for profit business for charitable purposes cannot be easily foreseen any more than the organizer of a for profit business can be assured that the next five years will follow the business plan like an actor following a script. The future is unknown and the operators of all three must be prepared to make mid course corrections as events unfold. The IRS understands this and in spite of its ugly image is there to help in the case of nonprofits and PRIs. All it wants is that the managers and operators keep their charitable mission in sight and make changes as needed to fulfill that mission.

20. IRS Approved PRIs

Are there other examples of IRS approved PRIs?

Treas. Reg. § 53.4944-3(b) Example 5 describes a below-market interest loan by a private foundation to a business enterprise that is financially secure and the stock of which is traded on a national exchange, made to induce the company to establish a new plant in a deteriorated urban area. Due to the high risks involved, the company would be unwilling to locate a plant in this area absent the private foundation’s inducement. Example 5 concludes that the investment is program-related, even though the loan is made to a large, established, publicly-traded company.

Similarly, in Priv. Ltr. Rul. 199943044 (July 26, 1999), the IRS approved an arrangement wherein a private foundation purchased stock in a for-profit business that operated in a region designated as economically depressed pursuant to an agreement that required a set percentage of the for-profit’s employees to have been previously unemployed or underemployed.

In Priv. Ltr. Rul. 8807048 (Nov. 23, 1987), the IRS has ruled that a private foundation’s purchase of a large equity interest in a company that would, through two subsidiaries, make substantial investments in new or expanding business ventures in an economically depressed region and provide small local businesses with access to debt financing qualified as a PRI.

In Priv. Ltr. Rul. 199910066, the IRS considered the investment by two private foundations in a limited partnership having an LLC as the general partner. The LLC members were local universities. The purpose of the partnership and LLC was to exploit technology developed by the universities and support new companies in the economically depressed area in which they were located. The IRS ruled that the foundations’ proposed investments would qualify as PRIs.

Recently, in Priv. Ltr. Rul. 200610020 (December 13, 2005) the IRS ruled that a private foundation’s capital contributions to a for-profit fund structured as an LLC dedicated to angel investing in low-income communities, as well as providing educational programs and technical training, qualified as a PRI.

The foregoing authorities reveal that the IRS has ruled on multiple occasions that a foundation’s investment in a for-profit entity—including an investment in a charitable-purpose LLC—may qualify as a PRI, provided that the entity satisfies the requirements set forth in Treas. Reg. § 53.4944-3(c). The fact that the entity’s name contains the L3C designation does not alter the legal framework for analyzing whether the foundation’s investment in the entity would qualify as a PRI.

IN 2012 the Treasury Department amended 26 CFR part 53 to add new examples of PRIs many of which are most appropriate for L3Cs.
21. Nature of Objectors

*Why do so many of the objections to the L³C seem to come from business attorneys?*

I think there is something that almost everyone has failed to note and that is the lack of knowledge by the attorneys who make many of these negative comments and cause us so much pain. It starts with the word “hybrid.” If the L³C is a hybrid because it has one foot in the business world and one foot in the nonprofit world then those who provide needed services such as attorneys and accountants need to have a foot in both worlds too. Once you leave behind your small neighborhood law office and shoe store where you can buy everything, you get into the world of legal specialization. There are only a small number of attorneys who are fully proficient in both areas. The numbers of consultants and accountants is even less. Most of the attorneys who have been critical of the L³C are from the business bar. They do not understand the nonprofit world which is the domain of the taxation bar. Foundations are governed by the IRS and that is tax bar territory.

The IRS treatment of PRIs is much closer to the way the securities regulators and the securities attorneys look at things. Since 1969 the IRS has applied a kind of sophisticated investor rule to PRIs. Foundations are responsible for the PRIs they make and are expected to do the due diligence needed to insure that their investments qualify under the law. Business attorneys often claim that one of the evils of the L³C is that it might induce foundations to make PRIs that they should not make. For the foundation telling this to the IRS is akin to saying the dog ate my homework - lots of luck with that one.

Business lawyers do not understand that the same rules apply if the foundation makes a grant to a 501(c)(3). The foundation must do due diligence to be sure the alleged nonprofit does in fact have that status. Again if they cannot show reasonable efforts it is the dog ate my homework bit. In the nonprofit sector all of the players, even the little corner charities have a raft of rules and regulations with which they must comply. Primary responsibility rests with them. Regulators normally look at them after the fact and punish them if they failed to comply. Almost every one of these situations is based on a fact and circumstance type of analysis. Everyone panics over private inurement rules but the truth is if you run a charity you can hire your brother-in-law and rent his garage but there are a lot of hoops to jump through to get there. And after the fact you generally cannot call the IRS and ask permission to do so. You are expected to work with your attorney or accountant and figure it out at the risk of IRS penalties later on.

Business attorneys are just unfamiliar with this world and overreact. What amazes me is that people and legislators listen to them. If a legislative committee were holding a hearing relevant to brain surgery how many podiatrists do you think would be invited to speak even if they are doctors? For some reason there seems to be an arrogance by part of the business bar which says if its law we are experts. We need to start calling these attorneys on their lack of qualified standing.

22. How the L³C Effects the Charitable Dollar Pool

*Some nonprofits are concerned that money invested in L³Cs by foundations will be dollars that might otherwise have been used to make grants to nonprofits. Is this a reasonable fear?*
This question is usually asked in a somewhat fearful manner by charities who are concerned that lots of foundations will start using their required 5% allocation for PRI’s instead of grants. The short answer is that on a macro level it is not a threat and use of the L3C will greatly increase the dollars available for charitable purposes.

We need to think of the entire charitable sector as a pool that presently contains a fairly measurable, finite amount of money. Every year donations are made and money is used for various purposes but the total adjusted for inflation is fairly consistent. One of the major purposes of the L3C is to bring more money into the pool hopefully by a factor of 5 or more. This will be done by making many solutions to charitable problems solvable by applying business solutions. The PRI component of the L3C does this by absorbing most of the risk thereby attracting commercial and institutional investors to a project.

As a result many charities, over time, may be able to change the way they work by sponsoring businesses organized as L3Cs that put people to work at well paying jobs rather than needing handouts. In many cases the need for pure charitable dollars will be reduced taking pressure off already overburdened nonprofits. In many cases our charitable sector gets caught in a syndrome characterized by the old southern saying, “When you are up to your behind in alligators it is hard to remember that your original goal was to drain the swamp.” The purpose of charity is to relieve problems not institutionalize them. If we can put people to work in meaningful jobs or make a symphony orchestra self sustaining then we have reduced the need for charitable dollars in those areas and more of what is left can go to other needed areas.

This does not mean that some nonprofits may not find that an L3C can do the job better than a nonprofit and the nonprofit will need to adapt. But best practices for foundations embody the concept that the foundation should at all times be looking for the best way to solve and remediate social problems. It has long been recognized that for profit businesses are the economic engine behind our country and create the most and best paying jobs. For profits are tax paying entities and not tax using entities as are many nonprofits. I fully support and admire the work of the nonprofit sector but to the extent we can convert any of the work of the nonprofit sector to the for profit sector we will all be richer for it.

23. Validity of Changes to L3C Statutes Suggested by Some Attorneys

Should L3Cs be required to have at least one bona fide economic member that is a qualified tax-exempt charitable or educational organization within the meaning of IRC § 501(c)(3)? Should the L3C statutes be changed to suggest that only “one or more limited liability company interests” must be charitable in nature, not the entire company as currently stated in the existing L3C enabling legislation?

The advocates of these changes miss the point of the L3C law. Our attempt is to create an entity which is first and foremost a for profit venture but one whose primary job is fulfill a charitable mission. But this question misses the mark because it fails to recognize that the present law permits an L3C to engage in one or more businesses that are not directly related to its mission. As we have already pointed out, Endless Sky L3C is being formed in Montana for the express purpose of processing food for the food banks and soup kitchens in Montana. In order to do so it will create and market a high end iconic branded retail line of food which it will sell at market price. But the
revenues from that line, will support the food bank line. The revenue from the retail line will cover the entire overhead and profit not used to repay investors will also go to support the food bank line. In fact Endless Sky could not function except for its non charitable product line.

24. Progress of Passage of L³C Statutes

The passage of L³C laws does not seem to be moving as rapidly as it once did. Does this mean the law is flawed or states should reconsider adoption?

No. The legislative process moves in spurts. There are always the early adopters who understand the promise of a new idea and then there are those who want to wait to see what everyone else does. I remember testifying before a legislative committee before any state had adopted the law and at the end of my testimony saying, “...and you can be the first state to adopt this law.” Whereupon one legislator promptly said, “I don’t cotton much to number one. I prefer to be number 25.” The first state law was passed in 2008 just before the beginning of the Great Recession. That recession has made it challenging to finance any venture let alone a new and untried one. It is way too early to judge the L³C. There are many happy users and some who are disappointed because they thought organizing as an L³C would bring foundations to their door with bundles of cash. Unfortunately, or maybe fortunately no form of business organization eliminates the need for a good business plan and as a new idea the L³C will undoubtedly take a while to gain widespread acceptance.

I am proud to have created the L³C and hope more and more states will pass the enabling legislation and that more and more people will find value in its use every year. Any suggestions regarding changes to the law should not be based on theoretical discussions but come from a consensus after several years of use.